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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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THE MARKET Letter 190 (page 3) took note of the new recovery high in the Industrial Average. After calling attention to the relationship of the Industrials and the advance-decline ratio, that Letter stated: "If another day or so of rallying action succeeds in taking the A-D ratio above point E and then above point A (the July 12 peak), the market will be in position to extend its advance (perhaps dramatically so)."

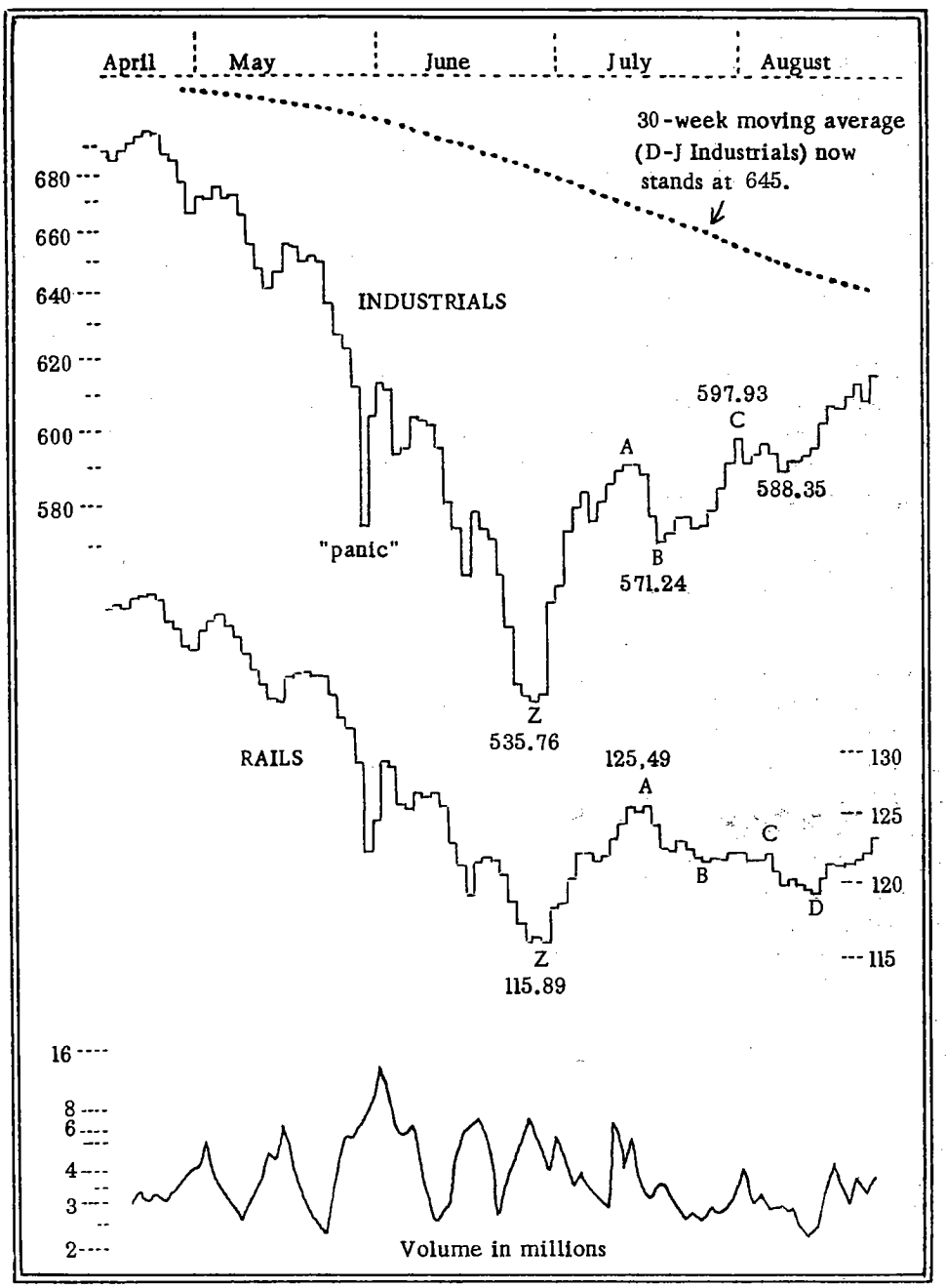
On August 15 (one day later) the A-D ratio did better its July 12 peak, thereby confirming the Industrial Average and eliminating a possible bearish divergence between the "blue chip" stocks (the Industrial Average) and the rest of the market (the A-D ratio).

From the standpoint of Dow's classic Theory, the "fly in the ointment" has been (and is) the persistent refusal of the Rail Average to better its own July 12 high of 125.49. As stated in Letter 190: "One of the two Averages is now telling the true story. If Industrials rise to a new recovery high followed by an 'in gear' advance in Rails, the situation could yet resolve itself into one of gathering strength (assuming that Rails eventually confirm by bettering their preceding peak of 125.49)."

Beginning August 15, Rails finally did get in gear with Industrials, and as of this writing the carriers are within two points of their July 12 peak.

This writer does not want to play the "kill-joy" during what appears to be a violent secondary correction. But since I advocated trading positions at point B (in the 570-75 area), I feel I am also entitled to discuss possible forthcoming danger signals (in an attempt to get subscribers in and out of a move with profits).

(1) Since mid-July, odd-lotters have remained sceptical of the rise (they have been sellers). Sooner or later, they will switch their sentiment and decide that the market "really is heading higher." Such a switch in sentiment will represent technical deterioration. In 1961 the peak of odd-lot selling (perhaps coincidentally) came within a week of the peak on the



A-D ratio. So far, the peak selling area was recorded around August 17, but there has been no marked trend towards buying the advance as yet.

(2) In 1961 the Rail action was characterized by a series of non-confirmations and divergences, interspersed with sudden explosive one and two-day rail rallies. Each of these "spikes" in the Rail Average proved (in retrospect) to be an area of distribution, and each was shortly followed by a general market sell-off. Therefore, I would be sceptical of any sudden (violent) rise in the Rail Average (whether to new recovery highs or not). In October, 1961, Rails spurted over seven points within a few days and finally bettered their March, 1961 peak. This late drive proved to be the end of the move for Rails.

I might add that the longer the time lag prior to final Rail confirmation, the more diluted the significance of such confirmation. In the present situation, a month and a half has passed since the July 12 Rail peak of 125.49. Therefore, a sudden rise to new recovery highs by Rails (although hopeful) would not have the bullish implications that might have been the case had Rails confirmed a month ago. If Rails spurt to or above the July 12 peak -- and immediately turn down -- I would view the action as distinctly unfavorable if not ominous.

CONCLUSION: The primary trend is bearish. The secondary trend turned bullish on June 26. The minor or daily trend is also bullish as of this writing.

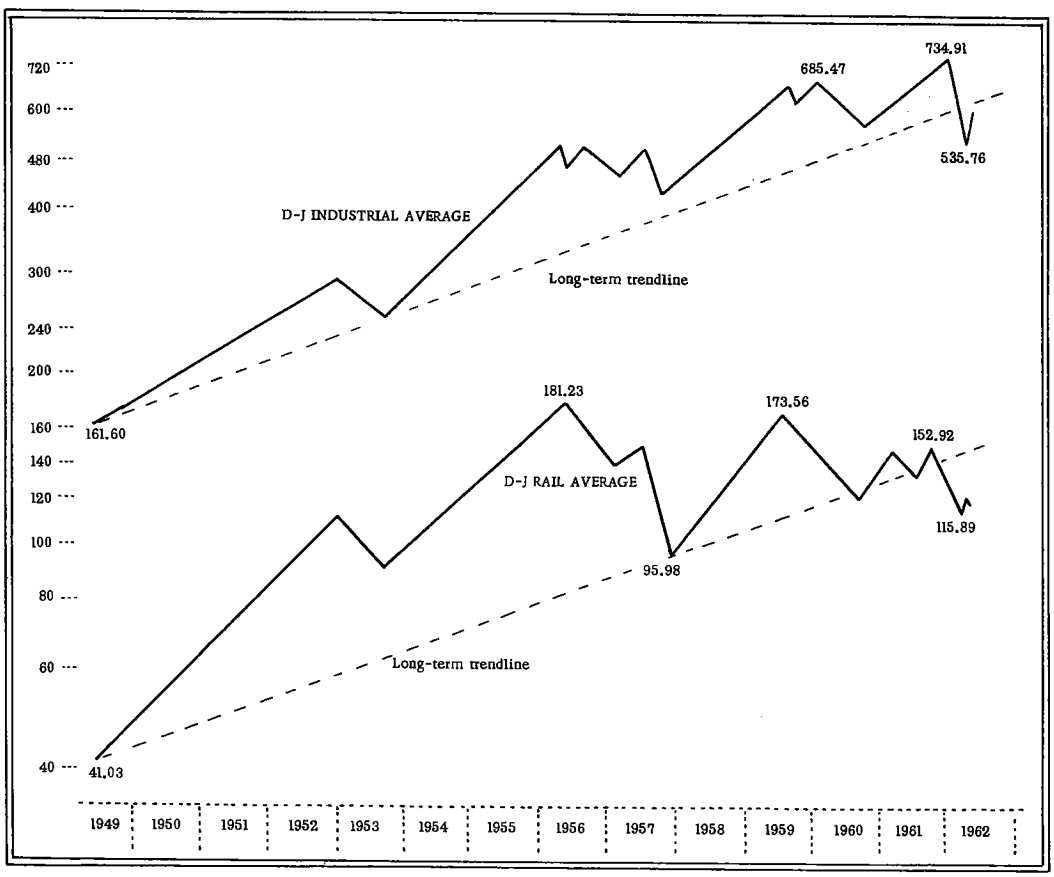
1949-1962 Periodically, I present a chart of the long-term swings of the Averages. I do this in an attempt to bring some sort of order out of chaos (every investor knows that the short-term picture always appears to be pure chaos).

The accompanying chart is drawn to logarithmic scale. In other words, it measures percentage of increase or decrease. On logarithmic scale a steady rate of upward (or downward) thrust can be measured by a trendline. As long as that rate of movement continues, the trendline will hold.

Drawing trendlines through the two lowest extremities of the upward movement which began in 1949, we note that the Rails broke below their trendline in 1960 and Industrials finally broke their trendline in 1962.

Of interest is the time element of the four major upward swings since 1949. The 1949-53 rise was longest, the 1954-57 rise was shorter, the 1957-59 advance was even less sustained, and the 1960-61 move was briefest of all. Following the abbreviated 1960-61 effort, Industrials turned down to record their most drastic percentage decline since 1937.

In 1956 the Rail Average recorded its bull market peak of 181.23 (see chart). The 1959 Rail advance halted at 173.56. The feeble 1961 Rail rise stopped at 152.92. This increasing Rail weakness was accompanied by deceptive "strength" in Industrials. Following the 685.47 Industrial high of 1960, Industrials dropped sharply, only to push up two years later (December, 1961) to an historic peak of 734.91. The 1961 Industrial high (obviously unconfirmed by Rails) was, however, only 49 points above the peak set two years earlier. Subsequent to the 1961 high, both Averages finally got "in gear" in a major way by turning down and plunging through their 1960 lows. In retrospect, the persistent and dramatic weakness in the carrier index from 1959 to 1962 was an omen worth heeding.



But what of the picture now? One thing that occurs to me is that in view of the continuing Rail weakness and the 1962 breaking of the Industrial trendline, the argument for a major bearish reversal of trend is now stronger than at any time since 1949. If this is so, all upward swings (regardless of how impressive they may appear at the moment) must be viewed with suspicion. They should be treated as secondary reactions against the primary downward trend. Furthermore, because of the shattering of the long-term trendline, I believe that the case for the eventual appearance of a classic bear market bottom is now better than ever. In the absence of such a bottom, I

personally will remain sceptical of all talk of "a new bull market." This argument will be amplified in the next section.

THE BIG PICTURE Bears who counted on a continued collapse throughout 1962 are now understandably annoyed. Late-come who put out lines of shorts in June (and failed to cover) are wondering whether "the stock market will ever make sense." Whi no man can claim repeated successes in identifying important turns, there is nevertheless a good deal more logic and reason behind the movements of the market than is generally conceded.

This writer (while claiming no extraordinary skills) spends a good part of his waking hours attempting to "figure" the market. Part of 1962's efforts are listed as follows: Letter 185 (June 25) -- "The Industrial Average has lost approximately one-quarte of its value in a period of six months. Whatever else may be said, we are now 190 points nearer a secondary (upward) reaction." And later in that Letter: "With Industrials down 200 points, it strikes me that fresh positions on the short side can hardly be considered brilliant (many subscribers have been in an all-cash position through the greater part of this collapse, an they consider this to be brilliant enough)."

From Letter 186 (July 5): "The action of the market since June 28 has obviously been the most impressive since the second le of the bear market began in March, 1962. From the standpoint of a possible secondary (upward) correction, further evidence on the bull side of the ledger is as follows: on May 29, with Industrials in the 570 area, the five-day average of daily new lows struck a peak of 713. The highest figure since then, 256, came on June 27 with Industrials in the 530-40 area. Thus, more and more stocks resisted the bear trend as the Averages probed new low territory. Volume too, tended to contract with recent thrusts by the Averages into new low ground."

More from Letter 186: "Two points worth considering: Historically, post-crash recoveries tend to retrace 40-60% of the groun lost during the preceding bear leg. If the correction carries nearer 60% than 40%, the chances for making money will be greatly enhanced."

Letter 187 (July 16): "The odds now favor a nearby "shakeout" (which could erase perhaps 1/3 to 1/2 of the rise) followed by a second upward move which will probably go to new recovery highs.... Following a decline of this type (which could start at any time) I believe trading positions will be in order. It should be remembered that the current secondary has arrived following an historic 200-point crash collapse. In view of this and in view of the fact that secondaries normally last three weeks to three months, I continue to believe (as stated in Letter 184) that the correction will be of the larger and more sustained variety."

Letter 188 (July 25): "Subsequent to a panic-collapse, the Averages usually regain 40-60% of the ground lost on the preced primary leg. In the present situation, a minimum 40% retracement of the second (190) point primary leg would take Industrials to 611. Judged by this standard, the current secondary is (so far) sub-standard in extent."

If the foregoing list of quotes causes new subscribers to believe that I have developed a "truly accurate timing device" -- forget it. Almost every Letter I write (with rare exceptions such as Letter 180) is interspersed with doubts, perplexities (and even counter-arguments). However, I submit that the action of the market from January, 1962, down to the June lows - and the action since -- was subject to reasonably intelligent interpretation. That action had definite parallels in market movements of the past.

With increased frequency, I am being bombarded by notes from readers who insist that the rise since June 24 should be considered part of a new bull market. One subscriber writes that "most stocks topped in 1959 as did Barron's Business Index. Th we may be seeing the beginning of a new bull market following a three year bear market." Unquestionably a majority of stocks have suffered severe losses over the past few years. But in the market we are always dealing with probabilities. In my opinion, probabilities do not favor the development of a new primary bull market at this time.

One thing that keeps me sceptical is that the signs of a classic bear market have not appeared. Average yields at the Jul 1962 lows never got much above 4%. I would expect average yields of 6% or more (on the Industrial Average) at a major be market bottom. There has been no great collapse in Barron's Low Priced Stock Index, although that Index did drop from a 1959 peak of 250 to a 1962 low of about 155. No sustained area of depressed investor psychology appeared around the 1962 lows. Such areas are characteristic of the third (and final) phase of a bear market. Most bear markets terminate on extren low volume (volume of perhaps 10% of that which occurred at the preceding bull market top). But volume was running extremely high in June. Finally, there was no extended sideways "drag" of the Averages at or preceding the bear market lo (rather the market "turned on a dime"). Most bear markets end with something approximating a final dull, dragging moven

That the current secondary (upward) correction may be a great one, I am perfectly willing to concede. That it may wind up looking like "the real thing" (a new bull market) has never been far from my mind. But I do not believe that we are witnessing "a new bull market." Therefore, I continue to be sceptical and stubborn (which means that if the advance is fated t go through the old highs, it will do so with my account far from fully committed).

LATE NOTES (Written Thursday, August 23, 2 P.M., N.Y. time). At this writing the market continues to push higher with volume increasing. Industrials are now about 16 points below the halfway level of the entire 1962 decline. This level should offer major resistance. Industrials are also 26 points below their 30-week moving average (see page 1), another critical resistance point. The market should now be watched carefully for signs of "churning" (high volume with relatively little upside movement). Churning action following a violent advance has marked the end of many secondaries.

STOCKS In Letter 187 I suggested "...that speculators buy a package of these seven stocks": Kaiser Alum. (31 3/8 -- 35 3/4), S.O. of Calif. (54 1/2 -- 58), Royal Dutch (36 -- 39 1/4), Amer. Can (43 3/4 -- 45 1/8), Polaroid (97 -- 108 3/4), Magnavox (31 3/4 -- 38 1/4), Beckman (83 1/4 -- 109). The first figure in parentheses shows the price of the stock on the opening -- July 19, which is about the time most subscribers received Letter 187. The second figure shows the price as of the opening today, August 23. These seven stocks now show an average appreciation of 15% (before commissions), which is no startling performance but not bad for one month's action. I would now think in terms of protecting these profits in case of a reversal. Profits are hard to come by -- they can disappear rapidly. These stocks were recommended as speculations, not long-term holdings. For this reason, subscribers might even wish to sell half of their original commitments as "insurance" and "ride" with the rest (putting mental stop-losses under the remainder).

The last Letter (page 4) listed six stocks which I felt were considerably stronger than the market. I have included charts (below) of two stocks which are now worth studying.

Ford has completed an inverse "head-and-shoulders" accumulation pattern, and it is now working above the "neckline" (dotted line) on increasing volume. The stock has given a "buy-signal." United Aircraft has formed an irregular head-and-shoulder reversal and has also bettered its neckline on increasing volume. Thus a buy signal has been given by UR. Both of these stocks are in relatively strong groups; each belongs to that small list of stocks which refused to break their 1960 lows during the 1962 decline.

Charts courtesy of Traders Research, Inc., P.O. Box 2644, St. Louis 16, Mo.